Ontario Securities Commission
Commission des valeurs mobilières de l'Ontario
22nd Floor
20 Queen Street West
Toronto ON M5H 3S8
22e étage
20, rue queen ouest
Toronto ON M5H 3S8

IN THE MATTER OF THE *SECURITIES ACT*,
RSO 1990, c S.5

- AND -

IN THE MATTER OF
WAVERLEY CORPORATE FINANCIAL SERVICES LTD.
and DONALD McDONALD

REASONS AND DECISION
(Section 8 of the Act)

Hearing:	September 12, 15, 2016 October 11, 2016	
Decision:	March 1, 2017	
Panel:	D. Grant Vingoe	- Vice-Chair, Chair of the Panel
	Monica Kowal	- Vice-Chair
	William J. Furlong	- Commissioner
Appearances:	Michelle Vaillancourt Michael Denyszyn	- For Staff of the Commission
	Melissa MacKewn Natalia Vandervoort	- For the Respondents

TABLE OF CONTENTS

REASONS AND DECISION

I. OVERVIEW

[1] The Applicants, Waverley Corporate Financial Services Ltd. (**Waverley**) and Donald McDonald, have been registered with the Ontario Securities Commission (the **Commission**) as an exempt market dealer (**EMD**) and as Waverley's Ultimate Designated Person (**UDP**) and Chief Compliance Officer (**CCO**), respectively, since June 26, 2012. They are the subject of a decision of a Director of the Compliance and Registrant Regulation (**CRR**) branch of the Commission, dated July 15, 2016 (*Re Waverley Corporate Financial Services Ltd.* (2016), 39 OSCB 6657) (the **Director's Decision**).

[2] The Applicants sought and were granted a stay of the Director's Decision and have applied for a review of that decision. These Reasons and Decision result from the hearing and review in respect of that application conducted on September 12 and 15, 2016 and October 11, 2016 (**Hearing and Review**). For the reasons that follow, we order that the Applicants comply with the terms and conditions set forth in Part VIII of this decision.

II. BACKGROUND

A. History of the Matter

[3] On September 4, 2014, CRR Staff commenced a compliance review of Waverley for a review period from August 1, 2013 to July 31, 2014 (the **Compliance Review**). As Waverley began trading in May 2014, the Compliance Review only captures the first three months and the first 22 trades of the firm's operation. However, as discussed below, CRR Staff continued inquiring into Waverley's business beyond the Compliance Review period, including interviews, e-mail exchanges and requests for documents, evidence of which was presented to this Panel.

[4] On January 22, 2015, CRR Staff held an interview with Mr. McDonald to discuss the Compliance Review. At the interview, CRR Staff noted the deficiencies it had found and advised Mr. McDonald that it would be referring these deficiencies to the Registrant Conduct Team.

[5] CRR Staff delivered to Waverley its Compliance Field Review Report on July 3, 2015 (the **Compliance Report**). In the cover letter, CRR Staff stated that it was "not requesting a response at this time" with respect to the noted deficiencies.

[6] Following the release of the Compliance Report, CRR Staff and Waverley engaged in further discussions to resolve issues arising therein, some of which became the subject of this proceeding.

[7] On February 8, 2016, CRR Staff sent a recommendation letter to the Director (the **Recommendation Letter**) recommending that Waverley's registration be subject to certain terms and conditions.

[8] In response, on February 19, 2016, the Applicants requested an opportunity to be heard (the **OTBH**) in writing pursuant to section 31 of the *Securities Act*, RSO

1990, c S.5 (the **Act**). Written submissions were exchanged between March 14, 2016 and April 22, 2016. On May 25, 2016, the Director convened an in-person meeting between herself, CRR Staff and the Applicants in respect of the OTBH.

[9] On July 15, 2016, the Director issued the Director's Decision, in which she ordered that:

> - Waverley shall cease all activity conducted under the Issuer-Connected DR Model … and shall not sponsor a dealing representative, except in accordance with Ontario securities law, effective 30 days from the date of this decision to allow for an orderly transition; and
>
> - McDonald is required to successfully complete, and provide proof thereof for, the Osgoode Certificate in Regulatory Compliance and Legal Risk Management for Financial Institutions, by no later than July 15, 2017.

[10] The Director's Decision defined those dealing representatives who fall under Waverley's "Issuer-Connected DR Model" to be:

> - employees, principles [*sic*] or connected to an independent issuer and they exclusive[ly] market the securities of that issuer to clients through their registration with Waverley (i.e. they do not market or sell any other exempt security that is offered by Waverley);
>
> - primarily compensated by the issuer, but receives a commission from the sale of the securities that is split 90 to 95% to the Issuer-Connected DR and 5 to 10% to Waverley;
>
> - located in the offices of the issuer and conducts all registerable activity from that office;
>
> - required to pay a "desk fee", which is a flat fee to Waverley for use of technology and supervision and compliance oversight provided by Waverley; and
>
> - [required to] execute a Dealing Representative and Branch Services agreement, which is a business services agreement with Waverley.

[11] Rather than rely on the attributes of a business model for the purposes of these Reasons and Decision, based on the evidence presented in the Hearing and Review, the Panel chose to focus on the broad array of financial and family relationships affecting Waverley's dealing representatives, who account for most of the firm's revenues and trading activities, and on Waverley's issuer clients and the conflicts of interest and other business and compliance risks created by these relationships.

B. Introduction

[12] Waverley's business relies primarily upon marketing its services to issuers (**Sponsoring Issuers**), who introduce dealing representatives (**Representatives** or **DRs**) to Waverley in order to market their securities. Marketing to investors, who thereby become Waverley's customers, can be conducted directly or can occur through referral agents, who direct potential trades to Waverley's Representatives. Waverley markets its services to issuers as a way of avoiding the financial costs and compliance responsibilities that would be required of issuers if they were to register as dealers themselves, referred to, in such cases, as "captive dealers."

[13] As part of the service that Waverley offers to issuers, Waverley has undertaken, among other responsibilities, to:

a. train Representatives on the legal and compliance requirements involved in their sales activities;

b. maintain required books and records;

c. maintain required capital and prepare required financial statements;

d. interface with securities regulators, making all required filings (including National Registration Database (**NRD**) filings), developing and maintaining client intake forms for know-your-client (**KYC**) and suitability requirements and disclosing conflicts of interest;

e. conduct due diligence for each securities offering;

f. supervise referral fee arrangements;

g. review proposed sales for compliance with suitability requirements; and

h. update Representatives on changes in legal and compliance requirements.

[14] Waverley conducts its business using an independent contractor model under which its Representatives are not intended to be full-time employees of Waverley. The Representatives' business activities are conducted using a "virtual office model," in which the Representatives typically operate from locations connected with the Sponsoring Issuers.

[15] Representatives overwhelmingly sell only the securities of the Sponsoring Issuer that introduced them to Waverley. Many of the Representatives have either business connections, through business interests or roles with Sponsoring Issuers, or family connections with the owners or personnel of Sponsoring Issuers.

[16] Waverley is compensated through a combination of monthly desk fees paid by or on behalf of the Representatives and a share of commissions paid by the Sponsoring Issuers with, in cases in which commissions are directly earned by a Representative, the substantial majority of the commission dollars going to the Representative rather than to Waverley.

[17] Where the relationship between a Representative and a Sponsoring Issuer is perceived by Mr. McDonald to be direct, the Representative does not receive the direct payment of commissions. As discussed below, these Representatives nevertheless receive other benefits arising from their relationships with the Sponsoring Issuers.

[18] The sharing of commissions is further adjusted to reflect payments made to referral agents, which generally come out of the Representatives' share of commissions.

[19] These arrangements are not applied in a completely consistent manner and are subject to differing practices.

[20] In its application to register a new limited partnership in June 2014, Waverley described its business on its Form 33 – 109F6 as follows: "Corporate finance advisory services to small and mid-cap issuers." Waverley's new business plan did not disclose its intended business practice of sourcing Representatives from Sponsoring Issuers, a practice that became the core of its business. At no point in time was this business practice disclosed to the Commission in a business plan submitted as part of its registration application or in connection with its proposed change in corporate structure.

[21] Once CRR Staff learned of the business practice, Waverley was already trading on behalf of customers. The disagreements between CRR Staff and Waverley regarding this business practice were subsequently addressed by way of the Recommendation Letter and then through the OTBH, rather than being considered as part of Waverley's registration process.

[22] The Panel expects that novel features of any dealer's business be reflected in business plans submitted to CRR Staff or be raised in discussions with CRR Staff if no application is pending and if the activities were not reasonably covered in the firm's prior applications. It appears to the Panel that Mr. McDonald believes either that (i) Waverley's business practice is not novel and is essentially the same as the captive dealer model or (ii) Waverley's business practice and the captive dealer model are sufficiently similar that he could persuade CRR Staff of its permissibility after the fact rather than seek approval from the outset. The former view is erroneous since the captive dealer model, unlike Waverley's business practice, requires the issuer and its chief executive officer to be subject to registration and full Commission jurisdiction as registrants. The latter view is equally erroneous since this business practice raises material conflicts of interest and supervisory issues. Either perception suggests a potential lack of proficiency on Mr. McDonald's part in his understanding of the principles underlying Ontario securities regulation and our expectations of those seeking to conduct a securities business with the public. Mr. McDonald's lack of proficiency in these areas is confirmed by the evidence, as discussed below.

[23] Regardless of why the Applicants proceeded the way they did, this Panel is now required to consider the attributes of Waverley's business practices, including the perceived deficiencies in Waverley's management of conflicts of interest of its Representatives, its systems of control and supervision and Mr. McDonald's proficiency.

III. LAW

A. Nature of Hearing and Review

[24] Pursuant to subsection 8(3) of the Act, upon a hearing and review of a Director's decision, the Commission may "confirm the decision … or make such other decision as [it] considers proper."

[25] A hearing and review of a Director's decision is a hearing *de novo* and therefore a fresh consideration of the matter (*Re Sterling Grace & Co* (2014), 37 OSCB 8298 at para 24). The Commission may substitute its own decision for that of the Director (*Sterling Grace* at para 23; *Re Sawh* (2012), 35 OSCB 7431 at paras 16–17).

[26] Staff bears the onus of establishing that terms and conditions ought to be imposed upon the registrations of Waverley and Mr. McDonald (*Sterling Grace* at para 25; *Sawh* at paras 147–48).

B. Basis for Imposition of Terms and Conditions

[27] Section 28 of the Act provides that the Director "may impose terms and conditions of registration at any time during the period of registration of [a] company if it appears to the Director" that one or more of the following three tests are satisfied:

a. the person or company "is not suitable for registration";

b. the person or company "has failed to comply with Ontario securities law"; or

c. "the registration is otherwise objectionable."

[28] Each one of these tests, if satisfied, is a sufficient basis by itself for the imposition of terms and conditions (*Sterling Grace* at para 150).

[29] At the OTBH and at the Hearing and Review, Staff relied on the first two tests set out in section 28 of the Act; namely, that it is apparent that the Applicants have failed to comply with Ontario securities law and that Mr. McDonald is not suitable for registration.

[30] As we explain below, given our findings regarding the first two tests, we find it unnecessary to engage in an analysis of the third test: whether Waverley's or Mr. McDonald's registrations are otherwise objectionable.

[31] After a consideration of the first two tests, the Panel must then determine whether or not terms and conditions should be imposed on Waverley and Mr. McDonald and what, if any, terms and conditions are appropriate.

IV. FAILURE TO COMPLY WITH ONTARIO SECURITIES LAW

[32] Staff alleges that Waverley has failed to comply with numerous provisions of Ontario securities law, including:

a. subsection 25(1)(b) of the Act, which requires dealing representatives to act on behalf of their sponsoring firm;

b. subsection 32(1) of the Act and section 13.4 of National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**), which describes the requirements of a firm in identifying and addressing conflicts of interest; and

c. subsection 32(2) of the Act, which sets out the control and supervision obligations required of a firm.

A. To What Extent are Waverley's Representatives Acting on Behalf of Sponsoring Issuers?

[33] Subsection 25(1)(b) of the Act states:

> Unless a person or company is exempt under Ontario securities law from the requirement to comply with this subsection, the person or company shall not engage in or hold himself, herself or itself out as engaging in the business of trading in securities unless the person or company,
>
> …
>
> (b) is a representative registered in accordance with Ontario securities law as a dealing representative of a registered dealer and is acting on behalf of the registered dealer.

[34] CRR Staff has issued guidance on its interpretation and application of this requirement in the context of regulatory concerns that some EMDs are inappropriately "renting out" their firm's registration to issuers who are avoiding the registration requirement. While it does not form part of Ontario securities law, OSC Staff Notice 33-746 – *Annual Summary Report for Dealers, Advisers and Investment Fund Managers*, published on September 21, 2015, which we note was a few months after the Compliance Report was sent to Waverley, states (at 54):

> A person or company engaged in the business of trading must be registered as a dealer. To comply with the dealer registration requirement, section 25(1)(b) of the Act requires that individuals not only be registered as dealing representatives of a registered firm, but that they be acting on behalf of that registered firm. A dealing representative who engages in, or holds themselves out as engaging in, the business of trading on behalf of an unregistered entity (such as their employing issuer) is therefore not complying with the dealer registration requirement.

We consider this guidance to accurately state the effect of subsection 25(1)(b) of the Act and turn to the application of this provision of the Act to Waverley.

1. Analysis

[35] Staff alleges that Representatives are acting entirely on behalf of the Sponsoring Issuers when performing registrable activities in contravention of subsection 25(1)(b) of the Act. On the record before us, we do not find such a breach.

[36] The Director, in her decision, found that Waverley's Representatives operating under the "Issuer-Connected DR Model" are not acting on behalf of Waverley and that, as a result, Waverley was in breach of subsection 25(1)(b) of the Act. The Director defined the "Issuer-Connected DR Model" as Waverley's business of providing "registration and compliance services to independent issuers by sponsoring an employee, principle [*sic*] or person connected to an independent issuer as a dealing representative."

[37] It is Staff's position, which it confirmed when questioned by the Panel, that some of the Representatives are not acting on behalf of Waverley at all but instead are exclusively operating on behalf of the Sponsoring Issuers with whom they are connected. In support of its argument, Staff pointed to the following:

a. Representatives are introduced to Waverley by Sponsoring Issuers with whom many continue to have close relationships;

b. Representatives sell only, or substantially only, the product of their Sponsoring Issuers;

c. desk fees payable by Representatives to Waverley are, in some instances, paid by an affiliate of their Sponsoring Issuer;

d. conflicts of interest continually arise from the relationships between Representatives and their respective Sponsoring Issuers;

e. Waverley relies, at least in some instances, on books and records prepared by Sponsoring Issuers as its own books and records (*e.g.* the trade blotters prepared by RESCO Mortgage Investment Corporation (**RESCO**);

f. Waverley has limited oversight over the marketing materials used by the Representatives;

g. Waverley remotely supervises the Representatives, who typically share office space with their respective Sponsoring Issuer;

h. Waverley appears to have a lack of control over substantial portions of the Representatives' compensation regardless of the written compensation arrangements in place; and

i. Representatives receive less compensation or fewer other financial benefits from Waverley relative to those that they directly or indirectly receive from their Sponsoring Issuers and thus do not appear to be financially dependent on Waverley, suggesting that Waverley consequently lacks authority over them.

[38] Staff argued in submissions to the Director that registrable actions of a Representative on behalf of its Sponsoring Issuer constitute a breach of subsection 25(1)(b) of the Act:

> In Waverley's case, the fact that [c]onflicted DRs primarily earn their compensation from their employing issuers, and not Waverley, demonstrates that they are in fact acting on behalf of their employing issuers. When the [c]onflicted DRs act on behalf of

> their employing issuers when soliciting or contacting directly any prospective purchasers, they are not complying with ss. [*sic*] 25(1) of the Act and they are removing the ability of the particular issuer to rely on s. 8.5 of NI 31-103.

[39] The Applicants submit that Waverley's Representatives solely perform registrable activities on the firm's behalf. The Applicants argue that Waverley's level of supervision is sufficient to demonstrate that the Representatives are acting solely on behalf of Waverley. The Applicants pointed out the ways in which Waverley takes the issue of "holding out" seriously, emphasizing the capacity in which Representatives are required to act as set out in their contractual arrangements, in customer communications, through the use of separate business cards and through training of the Representatives.

[40] The Applicants assert that, since Waverley markets itself as a registration alternative to issuers, the issue of Representatives not holding themselves out on behalf of the Sponsoring Issuers is at the very heart of Waverley's business conduct and is certainly not ignored by the firm.

[41] To find that Representatives are not acting on behalf of Waverley to any degree, as argued by Staff, we would have to find that:

a. the Representatives are in a continuing and material breach of contractual terms that:

    i. require them to carefully observe the capacity in which they are acting; and

    ii. do not provide them with the power to bind Waverley, with all trades remaining subject to Waverley's approval; and

b. Waverley is essentially no more than a compliance consultant to Sponsoring Issuers and their Representatives, who engage in registrable activities away from Waverley.

On the record before us, we are not persuaded this is the case.

[42] We are, rather, persuaded by the Applicants' evidence that Waverley's Representatives, at least to some extent, act on behalf of Waverley. Indeed, in some instances, the Representatives may act entirely on behalf of Waverley. In no instance, however, do we find that a Representative acts solely for his or her Sponsoring Issuer.

[43] It was open to Staff to advance the argument that Representatives who both conduct registrable activity on behalf of their Sponsoring Issuer and on behalf of Waverley contravene subsection 25(1)(b) of the Act. Staff declined to do so.

2. Conclusion

[44] To establish a breach of subsection 25(1)(b) of the Act, it is insufficient to demonstrate that Waverley performs its supervisory functions inadequately since that does not necessarily indicate that the Representatives are acting on behalf of the Sponsoring Issuer. Such evidence goes to the adequacy of Waverley's

supervision and compliance of its Representatives rather than to the capacity in which they are acting.

[45] Only by showing that Representatives act exclusively on behalf of Sponsoring Issuers would Staff be justified in seeking terms and conditions that substantially discontinue Waverley's business. To impose such terms and conditions, this Panel would need to be persuaded that Staff's specific concerns in respect of Waverley's business practice could not otherwise be remedied, which would have required more developed submissions from Staff.

[46] We conclude that no violation of subsection 25(1)(b) has been established such that Waverley would be required to discontinue its present business, provided that the shortcomings in compliance that we have identified are addressed.

B. Is Waverley's Management of Conflicts of Interest Adequate?

[47] Staff alleges that Waverley has committed breaches of subsection 32(1) of the Act and section 13.4 of NI 31-103 by inadequately responding to conflicts of interest between Waverley and its Representatives.

[48] Section 13.4 of NI 31-103 requires a firm to identify and respond to material conflicts of interest:

> (1) A registered firm must take reasonable steps to identify existing material conflicts of interest, and material conflicts of interest that the registered firm in its reasonable opinion would expect to arise, between the firm, including each individual acting on the firm's behalf, and a client.
>
> (2) A registered firm must respond to an existing or potential conflict of interest identified under subsection (1).
>
> (3) If a reasonable investor would expect to be informed of a conflict of interest identified under subsection (1), the registered firm must disclose, in a timely manner, the nature and extent of the conflict of interest to the client whose interest conflicts with the interest identified.

[49] The Companion Policy to NI 31-103 (**31-103CP**) describes conflicts of interest as "any circumstance where the interests of different parties, such as the interests of a client and those of a registrant, are inconsistent or divergent." Section 13.4 of 31-103CP sets out three methods to respond to conflicts of interest: avoidance, control and disclosure.

[50] 31-103CP provides further guidance that under subsection 13.4(3) of NI 31-103 "if a reasonable investor would expect to be informed of a conflict, a registered firm must disclose the conflict in a timely manner" and a registered firm must "explain the conflict of interest and how it could affect the service the client is being offered." Such disclosure should "be prominent specific, clear and meaningful to the client."

[51] The Panel notes that subsection 14.2(1) of NI 31-103 requires relationship disclosures to be provided to clients:

> A registered firm must deliver to a client all information that a reasonable investor would consider important about the client's relationship with the registrant.

[52] Paragraph (e) of subsection 14.2(2) of NI 31-103 requires this information to include "a description of the conflicts of interest that the registered firm is required to disclose to a client under securities legislation."

[53] The Panel interprets Ontario securities law to require Waverley to:

a. identify material conflicts of interest;

b. respond to the material conflicts of interest by appropriately disclosing, managing or avoiding the conflict; and

c. describe in writing to a client the conflicts of interest and how they could affect the service the client is being offered.

[54] Subsection 2.2(1) of National Instrument 33-109 – *Registration Information Requirements* requires registrants to submit Form 33-109F4 to the NRD website. Item 10 of the form requires applicants to complete Schedule G, which is titled, "Current employment, other business activities, officer positions held and directorships." Parts 3 and 5 of Schedule G require applicants to:

a. describe the duties for which they will be responsible at their sponsoring firm; and

b. disclose any potential for confusion by clients and any potential conflicts of interest arising from other employment, confirm whether the applicant's firm has procedures for minimizing potential conflicts of interest and confirm that the applicant is aware of those procedures.

[55] Staff further alleges that Waverley has breached paragraph (g) of subsection 32(1) of the Act, which states that every person and company registered under the Act shall comply at all times with Ontario securities law, specifically including regulations that relate to conflicts of interest.

1. Application

[56] Many of Waverley's Representatives have either business connections, through business interests or roles with Sponsoring Issuers, or family connections with the owners or personnel of Sponsoring Issuers. Waverley and these Representatives are dependent on or benefit from, to varying degrees, Sponsoring Issuers through desk fees paid by such issuers or their affiliates and, in the case of some Representatives, through employment income or capital appreciation.

[57] The Panel heard evidence relating to Representatives' conflict of interest disclosures that were provided to customers and conflict of interest descriptions in Representatives' NRD filings. Mr. McDonald stated at the Hearing and Review that he prepared each Form 33-109F4 for each Representative.

[58] The disclosures of the conflicts of interest arising from these outside activities and relationships made to customers and in the NRD filings are inconsistent and deficient. Additional disclosures are made in offering memoranda, potentially allowing an investor to gain a somewhat better understanding of the relationships by carefully parsing these multiple disclosures. In the Panel's view, this does not constitute clear and effective communication of these conflicts.

[59] We detail the deficiencies in Waverley's conflict of interest disclosures and NRD filings that were in evidence, with the expectation that they will be remedied by Waverley pursuant to our order in this matter and that future disclosures will be compliant.

(a) Chris Cheng

[60] Chris Cheng has been registered with the Commission as a Waverley Representative since February 2014. Mr. McDonald, in his testimony and as reflected in filings made under his direction, did not appear to be diligent in identifying potential conflicts of interest in relation to Mr. Cheng. For example, Mr. McDonald testified that RESCO and Radiance Mortgage Brokerage Inc. (**Radiance**), the manager of RESCO, are independent companies despite their common owners. He also does not readily recognize that the multiple roles Mr. Cheng has with RESCO, his Sponsoring Issuer, Radiance and 5C Capital Inc. (**5C Capital**), the administrator of RESCO, create material conflicts of interest.

[61] Mr. Cheng, in addition to being a Waverley Representative, is a Director and the Chief Operating Officer of RESCO and a Managing Partner of both Radiance and 5C Capital. The evidence provided indicates that Mr. Cheng is also a significant shareholder, in the range of 15–25%, of one or both of Radiance and 5C Capital. Radiance collects a management fee from RESCO in the amount of 1.5% of RESCO assets. 5C Capital receives an administration fee from Radiance equal to one third of the management fee Radiance receives from RESCO (*i.e.*, 0.5% of RESCO assets). The profit-earning vehicles for the owners of RESCO are therefore Radiance and 5C Capital, whose revenues grow as more securities of RESCO are sold.

[62] Mr. McDonald acknowledged in his cross-examination that, as a shareholder of both Radiance and 5C Capital, Mr. Cheng benefits financially from the sale of RESCO securities as the management fee for Radiance (and the corresponding administration fee for 5C Capital) increases with the size of RESCO's assets. However, he did not appear to appreciate the significance of Waverley's failure to appropriately identify Mr. Cheng's conflicts of interest to the Commission in its NRD applications. In response to the question on Mr. Cheng's NRD disclosure that asked the applicant to "disclose any potential for confusion by clients and any potential for conflicts of interest arising from your multiple employment or business related activities," Mr. McDonald responded on this NRD form that "the company [Radiance] as a mortgage broker, does not issue exempt products and we do not see the potential for any confusion." Mr. McDonald provided a similar answer in response to the same question in the NRD section that related to Mr. Cheng's relationship with 5C Capital, where he indicated that "5C Capital, the company, is a mortgage administrator, it does not issue exempt products and we do not see the potential for any confusion." Here, in completing this form on

behalf of Waverley, Mr. McDonald seemed to exclusively focus on possible client confusion as to which entity was offering securities rather than on the conflicts of interest arising from compensation arrangements that could reasonably be viewed as influencing Mr. Cheng's recommendations of RESCO securities to Waverley's customers.

[63] Mr. McDonald sought to justify Mr. Cheng's conflicts of interest by analogizing the benefit Mr. Cheng receives through an increase in Radiance's revenues from management fees, which increases with the size of RESCO assets, to the sales commission that a dealing representative receives when selling a product. This view, if accepted, would reduce these conflicts to the same level of significance.

[64] We reject the view that a commission paid by a dealer to a representative where the dealer is exercising appropriate control over the representative's activities is the same as a payment to the representative from the issuer, or a related party, where the representative is beholden to the issuer for his or her livelihood. In either case, as a general matter, the control of compensation can be used to either promote sales efforts that further compliance objectives or as leverage in sales efforts that are harmful to investors. However, a registrant's control over compensation with the attendant regulatory expectations and oversight over the registrant does not pose the same inherent compliance risks as the type of leverage over a representative's livelihood exhibited in this instance.

[65] Mr. McDonald appeared to minimize the significance of the fact that Mr. Cheng benefits financially from the sale of RESCO securities. When he acknowledged that a significant portion of his Representatives' compensation is derived from growing sales of their Sponsoring Issuers' securities due to their relationship to their Sponsoring Issuer, either as an employee of the Sponsoring Issuer or otherwise, he analogized the practice to a portfolio manager:

> My model is because there are other forms of benefit to the Waverley dealer rep, in this case the growth of assets under management, and I think I compared it before to a portfolio manager who is also registered as an EMD, they would be out collecting client funds and they benefit from increased AUM. So that's the exact same model here. Clearly my DRs benefit from the growth of AUM, which is why they do not receive a commission.

[66] In his testimony, Mr. McDonald did not communicate an appreciation for why an undisclosed benefit to a Representative derived from selling securities would be an important matter on which a reasonable customer would expect to be informed. Not all conflicts are equal. Unlike Waverley's Representatives, portfolio managers are fiduciaries of the investors whose assets they manage and have a legal obligation to act in their clients' best interest, and the arrangements would be required to be disclosed in material detail. Incentives provided directly by the Sponsoring Issuer to a Representative are particularly sensitive and are not of the kind that an investor would reasonably expect to exist in the absence of clear disclosure. They are essentially "secret commissions" that are obscured from an investor's view.

[67] At the time of the Compliance Review, Waverley had not provided a conflict of interest disclosure to any of Mr. Cheng's customers. Assuming that Mr. Cheng's

conflicts are not of a type that must be avoided, this disclosure failure breached section 13.4 of NI 31-103.

[68] Waverley's conflict of interest disclosures provided to Mr. Cheng's customers initially and for the period that Radiance paid desk fees to Waverley in respect of Mr. Cheng's registration make no mention of the fact that an entity that was benefitting financially from sales of RESCO securities was paying a monthly desk fee to Waverley in support of Waverley's continued sponsorship of Mr. Cheng's registration. Omitting this information from the customer disclosure is a deficiency.

[69] Mr. Cheng's current "Conflict of Interest Disclosure Statement" does not disclose the nature and extent of how his various positions could affect the interests of customers. For example, there is no reference to the fact that Mr. Cheng is a shareholder of Radiance and 5C Capital and that he benefits indirectly from his sales of RESCO securities. Again, omitting this information from the customer disclosure is a deficiency.

[70] The Applicants submit that a customer is not prejudiced by the non-disclosure of Mr. Cheng's shareholdings, as the implication of an indirect financial benefit may be drawn from RESCO's offering memorandum. These arguments are unpersuasive, as customers should not have to search multiple documents to parse together the implications of partially disclosed conflicts of interest affecting the investment services offered by a Representative.

[71] Waverley's conflict of interest disclosure to customers also does not explain how Mr. Cheng's conflicts of interest could affect the service the customer is being offered. In particular, customers are not informed that they are being offered, to an overwhelming extent, only one of Waverley's investment products. Nor are customers informed that Mr. Cheng's multiple roles with his Sponsoring Issuer and its affiliates are the reason for the constraint on the products being offered to them.

[72] Assuming that Mr. Cheng's conflicts are not of a type that must be avoided, these deficiencies in disclosure also contravene section 13.4 of NI 31-103.

[73] Mr. Cheng's Conflict of Interest Disclosure Statement goes on to express the view that:

> Chris Cheng's services as COO of the issuer and Dealing Representative of Waverley are integrated and generally not separable from each other when it acts as Dealing Representative on trades of RESCO MIC Class B Preferred Shares.

[74] If these roles are truly inseparable in terms of the duties owed to RESCO on the one hand and Waverley's customers on the other hand, even robust disclosure is insufficient and Waverley falls well short of that. Waverley's own statement clearly demonstrates that the conflicts of interest inherent in Mr. Cheng's dual capacity are not being managed effectively and therefore must currently be avoided.

[75] Taken together, the evidence before us leads us to conclude that Waverley, in its relationship with Mr. Cheng, continues to contravene the requirements under Ontario securities law to identify conflicts of interest; respond to the conflicts of interest by appropriately disclosing, managing or avoiding the conflict; and describe the conflict to a customer in terms of how it could affect the services offered to them.

(b) Chris Wong

[76] Chris Wong has been registered with the Commission as a Waverley Representative since February 2014. Mr. Wong is married to Phoebe Lam, a Director, Managing Partner and part owner of RESCO. She is also a principal of Radiance and 5C Capital. The nature of Mr. Wong's relationship with Ms. Lam creates a potential or actual conflict of interest with Waverley customers when he is selling RESCO products.

[77] The NRD form (Form 33-109F4, Schedule G, Part 3) requires applicants to describe the duties for which they will be responsible at their sponsoring firm. Waverley failed to meet this requirement with respect to Mr. Wong when it did not disclose that his primary role would be the marketing of RESCO units. Instead, it describes Mr. Wong's role as being "responsible for marketing approved exempt products" whose duties include "due diligence assistance on new issues, maintaining client relationships, [and] maintaining account and KYC information."

[78] Mr. Wong's NRD disclosure also does not identify his relationship with Ms. Lam. While this is not a conflict of interest from employment or other business activity requiring disclosure in the NRD filing, this non-disclosure prevented CRR Staff from learning of Mr. Wong's Sponsoring Issuer relationship from the outset.

[79] A conflict of interest disclosure was not provided to Waverley's customers in respect of Mr. Wong prior to the Compliance Review. Customers could reasonably expect to be informed of a family relationship, including a family relationship with a corporate officer, which may be perceived as creating economic incentives to recommend a certain investment product or to offer only one issuer's investment product.

[80] In addition, Waverley received desk fees from Radiance in connection with Mr. Wong up until June 2015. Waverley's conflict of interest disclosure for the period in which Radiance paid desk fees to Waverley in respect of Mr. Wong's registration was deficient. The disclosure made no mention of the fact that an entity that was benefitting financially from the RESCO capital raising was paying a monthly desk fee to Waverley in support of Waverley's continued sponsorship of Mr. Wong's registration.

[81] We find that Waverley's failure to provide conflict of interest disclosure to its customers prior to the Compliance Review in respect of Mr. Wong contravened section 13.4 of NI 31-103. These prior violations are sufficient to establish violations of Ontario securities law.

[82] In addition, Mr. Wong's current disclosure states that his advice "might be perceived as bias[ed] since he is related to the director of the Issuer" and that

"no assurance can be given that [he] would be considered to be independent within the meaning of the applicable securities laws." These descriptions are not, in light of Mr. Wong's circumstances, adequate affirmative disclosures concerning the effect of the conflicts on Waverley's customers, including the impact Mr. Wong's conflicts of interest have on the range of investment products he offers customers.

(c) Marshall Liang

[83] Marshall Liang has been registered with the Commission as a Waverley Representative since February 2016. He is also a mortgage broker with Radiance, receives a regular monthly salary from Radiance and reports directly to Ms. Lam in that role.

[84] Mr. McDonald confirmed in his testimony that his response on Mr. Liang's NRD application of "N/A" regarding possible conflicts of interest was satisfactory because he considered Radiance to be an unrelated business. This is inadequate disclosure in the circumstances because it fails to recognize the potential conflicts of interest that can arise when a dealing representative selling securities primarily of an issuer is also an employee of that issuer, which benefits when its securities are sold.

[85] Waverley does not provide customers with any conflict of interest disclosure in respect of Mr. Liang. Mr. Liang's employment with Radiance, the manager of RESCO, is a relationship of which a reasonable customer would expect to be informed. Customers should be informed of the impact that this relationship has on the services and the range of investment products they are offered. The Panel views this as evidence that Waverley failed and continues to fail to consider and evaluate the actual conflicts that exist between its Representatives and its customers.

[86] We find that the conflict of interest information provided by Waverley to the Commission via Mr. Liang's NRD filings is deficient and therefore breaches subsection 32(1) of the Act. We also find that Waverley's failure to provide a conflict of interest disclosure to its customers in respect of Mr. Liang constitutes a breach of section 13.4 of NI 31-103.

(d) Morgan Marchant

[87] Morgan Marchant became registered with the Commission as a Waverley Representative in April 2014. She is the daughter of Greg Marchant, a Vice-President and Director of MM Realty and an Executive Officer of one of the Legacy Lifestyles limited partnerships, both issuers who have engaged the services of Waverley and sponsored Ms. Marchant as a Representative.

[88] Customers were not informed of Ms. Marchant's conflicts of interest prior to March 2016. The Panel was provided with the current disclosure, a document entitled "Connected Issuer Disclosure." We find this disclosure to be ineffective since it does not plainly disclose how Ms. Marchant and her father's relationship may affect the services Ms. Marchant provides to Waverley's customers and the range of investment products she offers. Furthermore, references to the absence of a formal "economic interest" between them are not helpful to customers in

understanding the nature of the conflict and, in the Panel's view, are used to explain away the conflict rather than to specifically address the concern.

[89] The disclosure is also imprecise in its reference to limited partner versus limited partnership, as well as in its failure to state that the limited partnership is a connected issuer, not merely that it could be. This type of imprecision hampers the effectiveness of a conflict of interest disclosure by making it inaccessible and unreadable. We expect conflict of interest disclosures to be plainly written with the customer's comprehension as the primary objective.

[90] We find that Ms. Marchant's conflict of interest disclosure to customers falls short of the standard required under section 13.4 of NI 31-103.

(e) Theresa Johnston

[91] Theresa Johnston has been registered with the Commission as a Waverley Representative since December 2015. Ms. Johnston is also the Vice-President of Investor Relations for Canadian Mortgages Inc., a peer-to-peer lending platform for which Waverley is engaged to act as its agent.

[92] Ms. Johnston's NRD profile describes any potential conflicts of interest as follows: "Ms Johnston is a mortgage agent for CMI [Canadian Mortgages Inc.] and may be recommending title mortgage products to clients. While this is not a conflict, we will make it clear to potential investors when she is representing CMI with mortgage products or Waverley with other products." Staff submits that it should have stated "that Johnston was going to be selling units of a MIC that was managed by a company that shared the same ownership as her employer company."

[93] We find that the NRD conflict disclosure related to Ms. Johnston is inadequate and constitutes a violation of Ontario securities law.

(f) Other Representatives

[94] Jason Sucheki has been registered with the Commission as a Waverley Representative since April 2015. We were presented with evidence that, as of the time of the Hearing and Review, Mr. Sucheki's LinkedIn page states: "Through Waverley, we facilitate clients to become equity partners with MM [Realty]," which Staff submits demonstrates an employment relationship or business activity with MM Realty that should have been disclosed in his NRD profile.

[95] We conclude that the evidence with respect to Mr. Sucheki, although suggesting an employment or other relationship, is too indefinite to support Staff's submission.

[96] The Panel was provided with evidence relating to other Representatives in relation to Staff's allegations regarding breaches of subsection 32(1) of the Act and section 13.4 of NI 31-103. However, the evidence is insufficient for us to address these allegations in relation to these individuals.

2. Conclusion

[97] In each of the cases of Mr. Cheng, Mr. Wong and Mr. Liang, we find that there has been non-compliance by Waverley with both the NRD filing requirement and the customer conflict of interest disclosure requirement.

[98] In the case of Mr. Cheng, we find that the conflicts of interest are so severe due to his entanglements with his Sponsoring Issuer and affiliates that they must be avoided and, based on Waverley's present system of controls and supervision, are not capable of being dealt with through disclosure alone. We also find that in the case of Ms. Marchant, there has been material non-compliance with customer conflict of interest disclosure requirements. Furthermore, we find that Waverley's NRD conflict disclosure related to Ms. Johnston is inadequate and constitutes a violation of Ontario securities law.

C. Are Waverley's Systems of Control and Supervision Adequate?

[99] Subsection 32(2) of the Act requires registrants to "establish and maintain systems of control and supervision in accordance with the regulations for controlling [their] activities and supervising [their] representatives."

[100] Section 11.1 of NI 31-103 requires that a registered firm establish a system of control and supervision to:

> (a) provide reasonable assurance that the firm and each individual acting on its behalf complies with securities legislation, and
>
> (b) manage the risks associated with its business in accordance with prudent business practices.

[101] The Commission's jurisprudence has established that proper supervision is an essential component of a firm's compliance system. In *Re Rowan* (2008), 31 OSCB 6515, the Commission stated:

> The notion of "supervision" may be seen as shorthand for the array of systems, procedures, checks and balances that firms put in place to ensure that trading and other activities carried on with and for firm clients proceeded fairly and in accordance with applicable regulatory requirements and norms. Registered firms, and their supervisory and compliance procedures, serve as gatekeepers for dealings between the firms and the world outside. When they do their job, misconduct or simple error on the part of the individual personnel can be deterred or, failing that, detected promptly before harm (or further harm) to investors and the capital markets generally.
>
> (*Rowan* at para 312, citing *Re Roche Securities Ltd*, [2004] ASCD No 400 at para 151)

[102] Further, in *Sterling Grace*, the Commission stated that "dealing representatives must be connected to an appropriate compliance structure to ensure that a

responsible party has appropriate oversight of the trades conducted" (at para 213).

[103] The Panel finds that Waverley's systems of control and supervision are not effective in addressing key attributes of its activities and those of its Representatives. Accordingly, Waverley is in breach of subsection 32(2) of the Act and section 11.1 of NI 31-103, as detailed below.

1. Analysis

(a) Referral Arrangements and Related Books and Records

[104] Sections 13.8 and 13.10 of NI 31-103 permit registrants to enter into referral arrangements if they are appropriately disclosed to customers. Section 13.10 of 31-103CP provides guidance as to the disclosure of information that should be provided to customers. This information should be provided to customers before or at the time the referred services are provided, and registrants should take reasonable steps to ensure that customers understand the nature of the referral arrangement and any potential resulting conflicts of interest.

[105] Waverley and its Representatives source few, if any, of their own customers. They depend heavily on finders to generate customer relationships. Referral arrangements are clearly a critical aspect of Waverley's business.

[106] When Waverley started to implement its business practice in which Representatives primarily sell the products of Sponsoring Issuers, it did not have independent processes in place to manage its Representatives in respect of referral arrangements and to identify undisclosed referral arrangements. Specifically, there were no controls in place to ensure that such arrangements were appropriately documented by Representatives in written contracts with Waverley or that unauthorized payments were not made by others to finders in respect of sales made through Waverley.

[107] Mr. McDonald was not aware of this deficiency until he received an e-mail from Mr. Cheng on this matter on October 22, 2014. The same issue was raised several months later by Ms. Lam.

[108] No evidence was presented showing any specific recurrences of arrangements with, or payments to, unauthorized finders. However, with respect to Waverley's current practice regarding the monitoring of referral arrangements, Mr. McDonald stated, "If a DR doesn't get paid, but they're supposed to, I would hear about it." This does not demonstrate an established reconciliation system that would reveal whether a Representative or a Sponsoring Issuer entered into a referral arrangement or effected referral payments. A compliance system cannot solely rely on Representatives to monitor any potential breakdowns in that system. Waverley has failed to maintain adequate systems of control over this critical aspect of its business from the outset of its activities, establishing a breach of Ontario securities law. This is not a minor lapse in administrative practice but goes to the core of Waverley's business-generating activities.

[109] We are also concerned that Waverley appears to be excessively dependent, at least in some instances involving its most material Sponsoring Issuers, on the

books and records of these entities as the source of information necessary for the control and supervision of its own business. For example, Waverley depended on the trade blotters prepared by RESCO as its source of information on referral fees and commission payments without an apparent ability to control for the accuracy of this information. This concern leads to questions as to who at RESCO prepared the trade blotters and, if it was a Representative, in what capacity and on whose behalf he or she was acting when doing so. Since these questions were not addressed at the Hearing and Review, we draw no conclusions.

[110] From the outset of its operations, Waverley has failed to implement an adequate system of control and supervision in these critical matters involving referral arrangements as required by Ontario securities law.

(b) Marketing Materials and Due Diligence

[111] Waverley typically hires Representatives who, as discussed above, have an array of close relationships with Sponsoring Issuers. These conditions create a serious risk that Representatives have an inherent bias when promoting the securities of the Sponsoring Issuers.

[112] Among other supervisory implications, this serious risk of bias requires that Waverley carefully monitor Sponsoring Issuers' marketing materials to ensure they are fair and accurate. Further, the fact that many of Waverley's Sponsoring Issuers are in near "continuous distribution" (*e.g.* RESCO and MM Realty) places a responsibility upon Mr. McDonald as Waverley's CCO to ensure that marketing materials in these cases are subject to continuing review and are updated appropriately.

[113] The Panel finds that Mr. McDonald, and hence Waverley, does not demonstrate a comprehensive understanding of a dealer's critical role in reviewing issuers' marketing materials used in offers of securities to the public, as further discussed below. We expect registrants retained in corporate finance mandates to act as gatekeepers of Ontario's capital markets with respect to the key representations made to investors concerning an investment opportunity, regardless of dealers' disclaimers of liability to their customers or issuer clients.

[114] Waverley has no control system in place to identify and review the marketing material used by its Representatives, despite its responsibility under Ontario securities law and its obligation under the terms of its agreement with its Representatives.

[115] The DR Agreement dated December 12, 2013, between Waverley and Mr. Cheng states at section 4(b):

> During the currency of this Agreement, the Dealing Representative is authorised to use only those marketing materials which are pre-approved in writing by the Chief Compliance Office of Waverley. The Dealing Representative also agrees that he or she will always use only Waverley marketing materials in conformity with the Standards and Guidelines and in the manner from time to time specified by Waverley.

However, the evidence demonstrates that Waverley was not aware that its RESCO-sponsored Representatives used a product guide and slide deck prepared by RESCO to market RESCO investments to prospective customers of Waverley.

[116] Waverley was also not informed or aware of marketing materials of a Sponsoring Issuer. Problematic statements that encourage investment persisted on the RESCO website as of the date of the commencement of the Hearing and Review. Examples where Waverley should have engaged in a more careful and diligent analysis include:

a. representations of low mortgage delinquency rates in Canada generally being misapplied to specific lower grade market segments;

b. a comparison of RESCO product yields to interest rates paid by Guaranteed Investment Certificates without explaining the differences in products;

c. solicitations to the public on RESCO's website without reference to Waverley and without RESCO being registered; and

d. references that certain RESCO investments are less sensitive to interest rate changes without providing a sufficient discussion concerning factors affecting risk more generally, including default risk.

[117] The Applicants' counsel's assertions that other issuers of comparable securities made similar problematic statements suggest that Waverley believes that it is entitled to substitute the opinion of others rather than conduct an independent assessment of whether such comparisons are misleading. This is not the case. Waverley bears the responsibility of reviewing and forming its own assessment of the marketing materials used by its Representatives.

[118] The standard Agency Agreement between Waverley and the Sponsoring Issuers does not enable Waverley to review all marketing materials and to require changes based on its due diligence efforts.

[119] In its Engagement Letter with RESCO dated February 19, 2014, Waverley offers, but is not obligated, to assist RESCO in the preparation of appropriate marketing materials and any other documentation necessary to complete the financing. These services are on an "if desired" basis. RESCO does not give Waverley the power to insist on changes to their marketing materials.

[120] In its Agency Agreement with MM Realty dated July 3, 2014, Waverley is specifically required to not prepare or distribute any marketing, advertising, education or other promotional material in connection with the limited partnership units. This is antithetical to the role of a dealer in acting as an agent in a corporate finance mandate, for which the expectations are described above.

[121] Mr. McDonald provided evidence that he made certain changes in marketing materials in response to concerns expressed by CRR Staff. Mr. McDonald also testified that the Sponsoring Issuers would make changes to marketing materials if he asked for them, regardless of any contractual ability to insist on such changes. The Applicants' counsel also expressed a commitment that the Agency

Agreements with Sponsoring Issuers could be modified to include a provision that enables Waverley to insist on changes, if this Panel requires such a term.

[122] In any event, a critical review of marketing materials is not a function that Waverley consistently performs. Due diligence efforts, rather than being tied to the marketing materials utilized, appear to be more of an exercise to determine whether Waverley is willing to accept the offering as a threshold matter. This review does not routinely include claims made on the websites for those issuers or related parties. A registrant's due diligence review of an issuer should not be designed solely for the purpose of assessing whether to take the issuer on as a client. A due diligence review, among other things, is intended to assess and validate the fairness and accuracy of marketing materials.

[123] If an inadequate due diligence investigation overlooks a material misrepresentation, a registrant is not in a position to satisfy itself that the investment is suitable for a customer. The evidence relating to Waverley's limited due diligence procedures supports our conclusion that Waverley does not appear to have a sufficient know-your-product (**KYP**) process in place to properly support its obligation under section 13.3 of NI 31-103 to conduct suitability assessments.

[124] Mr. McDonald's evidence on the due diligence he conducted and his review of marketing materials lead us to conclude that he does not fully understand his responsibilities as a registrant and the interconnection between the due diligence function and the suitability assessment, and hence Waverley failed in its responsibilities in these respects. Waverley does not review the Sponsoring Issuers' marketing materials with the care and diligence required by a dealer under Ontario securities law allowing for potentially misleading materials to be used in marketing efforts on its behalf.

(c) Branch Offices

[125] The Commission has previously commented on a registrant's supervisory obligation with respect to branch offices. In *Re Argosy Securities Inc.* (2016), 39 OSCB 4040 at para 121, the Commission stated:

> In the case of a registered firm that has branch offices, this supervisory obligation necessarily extends to those branch offices, which by their very existence make supervision from the head office more difficult. The increased difficulty does not relieve the firm of its obligation.

[126] Waverley's virtual office structure poses additional challenges to effective supervision as compared to a structure where the UDP and CCO work in close proximity to his or her Representatives or a structure that has an alternative, effective means of supervision in place. Similarly, the conflicts of interest inherent in the relationships between many of Waverley's Representatives and their Sponsoring Issuers pose additional challenges as compared to a business model without these conflicts.

[127] These challenges must be addressed in a meaningful way with appropriate policies and procedures. They are not in this case.

[128] The Applicants submit that their written policies and procedures are sufficient, in part, because they were drafted by legal counsel. Upon review by the Panel, it is apparent that Waverley's policies and procedures manual is an off-the-shelf template and was not created with Waverley's compliance challenges in mind. For example, Waverley's current policies and procedures manual contemplates certain measures that have not been implemented, including a two-tier management structure and individual branch managers to supervise the activities of the Representatives.

[129] A firm's policies and procedures manual is an important document for ensuring compliance by a firm's representatives. The Panel expects Waverley's, and indeed all firms', written policies and procedures to reflect their actual business practices and to be responsive to the business and compliance risks posed by those practices.

2. Conclusion

[130] Throughout the Hearing and Review, Waverley repeatedly offered to fix deficiencies identified by Staff. This is an inadequate approach to supervision. A registrant must have systems of control and supervision in place to provide reasonable assurance that the firm, and each individual acting on its behalf, are complying with Ontario securities law. A firm is responsible for establishing and maintaining its compliance system. Waverley's practice of fixing key deficiencies found by regulatory authorities after the fact in areas that are central to its activities is an inadequate approach to compliance.

[131] The weaknesses that we have found involving the most central aspects of Waverley's control and supervision activities (*i.e.*, lack of compliance procedures tailored to the risks posed by its business, failure to supervise referral arrangements, lack of control over books and records, failure to conduct adequate due diligence in connection with marketing materials and inadequate branch office supervision) are significant and together represent a serious violation of Ontario securities law.

V. SUITABLE FOR REGISTRATION

[132] As discussed earlier, section 28 of the Act permits the Director to revoke or suspend a registration or impose terms and conditions on a registration in certain circumstances. One of these circumstances is when the person or company is "not suitable for registration."

[133] Section 28 of the Act does not specify how a lack of suitability is to be determined. We are guided by the same requirements applicable to an application for registration under section 27 of the Act.

[134] Subsection 27(1) of the Act does not explicitly prescribe a test for determining whether a person is "not suitable" for registration. However, it is appropriate to apply the considerations set out in subsection 27(2) of the Act applicable to an application for registration (*Sterling Grace* at para 149):

> **(2) Matters to be considered** — In considering … whether a person or company is not suitable for registration, the Director shall consider,
>
> (a) whether the person or company has satisfied,
>
> (i) the requirements prescribed in the regulations relating to proficiency, solvency and integrity, and
>
> (ii) such other requirements for registration … as may be prescribed by the regulations; and
>
> (b) such other factors as the Director considers relevant.

Paragraph (i) of subsection 27(2)(a) of the Act enumerates three criteria: proficiency, solvency and integrity.

[135] Staff alleges that Mr. McDonald's registration should be subject to terms and conditions pursuant to section 28 of the Act because he does not meet the necessary standard of proficiency of a CCO. We therefore limit our review to that criterion.

[136] Even if we conclude that Mr. McDonald did not act with sufficient proficiency at some time in the past, our inquiry does not end there. Section 27 of the Act requires us to assess Mr. McDonald's proficiency, and therefore his suitability for registration, as of the date of the commencement of the Hearing and Review.

[137] Subsection 3.4(1) of NI 31-103 requires that "[a]n individual must not perform an activity that requires registration unless the individual has the education, training and experience that a reasonable person would consider necessary to perform the activity competently … ." Subsection 3.4(2) relates specifically to the duties of a CCO and states that "a chief compliance officer must not perform an activity set out in section 5.2 [*responsibilities of the chief compliance officer*] unless the individual has the education, training and experience that a reasonable person would consider necessary to perform the activity competently."

[138] The Commission has held that the purpose of proficiency requirements is protective and intended "to ensure that the public deal with qualified registrants … [and] regulatory compliance and enhance the efficiency of the capital markets" (*Re Michalik* (2007), 30 OSCB 6717 at paras 48–49). The Commission has also held that "proficiency requirements are meant to ensure that registered individuals have a sufficient level of knowledge before providing dealing or advising services to clients, or compliance functions for their firms" (*Re Ittihad Securities Inc.* (2010), 33 OSCB 10458 at para 13).

A. Analysis

[139] Section 5.2 of NI 31-103 requires that a CCO, among other things, "establish and maintain policies and procedures for assessing compliance by the firm, and individuals acting on its behalf, with securities legislation" and "monitor and assess compliance by the firm" with these requirements.

[140] Waverley, under Mr. McDonald's direction, hires Representatives with an array of close relationships with Sponsoring Issuers. This business practice exposes a customer to serious risks since the Representative's interests may be closely aligned with his or her Sponsoring Issuer.

[141] The alignment of interests between a Representative and a Sponsoring Issuer increases the complexity of Waverley's business and compliance risks, requiring that a CCO be capable of responding to these more complex risks through a system of appropriate controls and supervision. The proficiency required of a CCO is not satisfied solely by passing qualifying exams. Proficiency is gained through accumulated relevant experience that is then applied from the commencement of a firm's business and adapted as circumstances change.

[142] It is the view of the Panel that Mr. McDonald has not demonstrated the proficiency necessary to establish and maintain policies and procedures that reasonably ensure compliance with Ontario securities legislation by Waverley and its Representatives in a manner that is attuned to Waverley's business and compliance risks.

[143] The Panel does not consider that its conclusions hold Mr. McDonald as CCO of Waverley to a higher standard than CCOs of other EMDs. Rather, the Panel is holding Mr. McDonald to a standard of proficiency dictated by Waverley's business practices.

1. Managing Conflicts of Interest

[144] The Commission has found that a failure to identify or respond to conflicts of interest raises proficiency concerns in circumstances where it appears that registrants do not adequately appreciate their responsibilities to customers (*Sterling Grace* at para 193).

[145] Waverley's business practice of hiring Representatives aligned with Sponsoring Issuers creates the potential for acute conflicts of interest between Waverley and its customers. This situation requires Mr. McDonald, as the firm's CCO, to be focused on and skilled at identifying and managing these conflicts. It is critical for the protection of Waverley's customers that these conflicts are effectively identified and responded to on a continuing basis. Mr. McDonald must monitor and assess whether Waverley's Representatives are prioritizing the interests of their Sponsoring Issuers over those of Waverley's customers.

[146] In response to a question from the Panel, Mr. McDonald stated that he considers the conflict of interest disclosures provided to its customers to be sufficient. As we have found in the cases of at least Chris Cheng, Chris Wong, Marshall Liang and Morgan Marchant, whose activities account for the vast majority of Waverley's activities under review, these disclosures are deficient. Mr. McDonald's failure to adequately address this fundamental issue for the protection of Waverley's customers is problematic.

[147] It also gives the Panel concern that Mr. McDonald consistently failed to correctly provide the information required by Form 33-109F4 for his Representatives, including the following items of information:

a. their potential conflicts of interest arising from outside employment;

b. whether the firm has procedures for minimizing potential conflicts of interest;

c. whether the Representative is aware of those procedures; and

d. if the Representative does not perceive any conflicts of interest arising from this employment, to explain why.

[148] When confronted with this deficient disclosure by Staff at the hearing, Mr. McDonald explained that investors would be able to get this information by parsing together these disclosures with the disclosure provided in documents used for particular offerings.

[149] Continuing his testimony, Mr. McDonald suggested that the deficiencies in the Representatives' NRD filings and the conflict of interest disclosures could have been corrected at the outset had CRR Staff raised these issues with him at an earlier time. The Panel rejects this suggestion. As CCO, it is Mr. McDonald's responsibility to ensure compliance with Ontario securities law by Waverley and its Representatives. CRR Staff's procedures in processing applications and examining for compliance are not a substitute for careful compliance by the firm itself. It appears to us that, too often, Mr. McDonald thought it was sufficient if he corrected matters brought to his attention by CRR Staff rather than being compliant in the first place.

[150] Mr. McDonald testified that, when he crafted the conflict of interest disclosures for those Representatives introduced by RESCO, he considered Radiance and RESCO to be independent entities. He therefore concluded that there was no need to disclose that Radiance was paying desk fees to Waverley on behalf of some of those Representatives. The Panel rejects Mr. McDonald's analysis regarding these two entities. Radiance earns income related to the sale of RESCO securities. Mr. McDonald's assertion that these two entities are independent for the purpose of conflict disclosure demonstrates his lack of proficiency.

[151] The evidence in this proceeding raises serious concerns for the Panel regarding Mr. McDonald's proficiency with respect to his understanding, identification and proper management of conflicts of interest from the time of the first NRD application for a Waverley Representative and continuing up to the date of the commencement of the Hearing and Review.

2. Systems of Control and Supervision

[152] Mr. McDonald, as CCO of Waverley, has not implemented a system of control and supervision that adequately responds to the close alignment of interests between Waverley's Representatives and their Sponsoring Issuers. The Panel concludes that Mr. McDonald has not demonstrated sufficient proficiency in this regard.

(a) Marketing Materials and Due Diligence

[153] Given this close alignment, Mr. McDonald needs to be particularly vigilant in identifying and responding to the risks to Waverley's customers arising from the

use of unapproved marketing materials prepared by Sponsoring Issuers, especially with Waverley's Representatives acting in potentially multiple capacities. His failure to implement robust procedures to ensure that fair and accurate marketing materials are used gives the Panel serious concerns regarding his proficiency in carrying out financing mandates. Since Waverley is often engaged by issuer clients involved in ongoing distributions, Mr. McDonald must exercise continuing quality control over these materials to avoid materially misleading disclosures.

[154] When presented by Staff with examples of potentially misleading disclosures in Sponsoring Issuers' marketing materials, Mr. McDonald provided weak rationalizations to the Panel. First, he stated that, since similar statements can be found in equally poor disclosures used by other issuers, this embodies an acceptable industry disclosure practice. Second, he maintained that, where multiple dealers are involved, any one dealer is unable to control an issuer's disclosure practices without recognizing the responsibility of each dealer to decline to participate in any offering based on misleading marketing materials. The Panel finds these reasons to be completely unpersuasive and further finds that such rationalizations show a lack of proficiency up to the date of the commencement of the Hearing and Review. Dealers must rely on their own judgment and must always make an independent decision whether to lend its name and credibility to an offering.

[155] We reviewed the examples presented to the Panel relating to Mr. McDonald's due diligence procedures. The evidence confirms our concerns that his process mainly comprises of a passive acceptance of information from others and a lack of critical analysis of the products being considered. The Panel was not persuaded that the evidence supported Mr. McDonald's proficiency in relation to the due diligence process.

[156] It appears to us that Mr. McDonald views his due diligence efforts as primarily an intake or engagement process. Going forward, it is vital that Mr. McDonald understand that such due diligence procedures are essential aspects of his gatekeeping role in ensuring that Waverley provides its customers with accurate and balanced materials with which to make investment decisions in support of an appropriate customer suitability assessment.

(b) KYC and Suitability Obligations

[157] Section 13.2 of NI 31-103 requires a registrant to take reasonable steps to ensure that it has information regarding a client's investment needs and objectives, financial circumstances and risk tolerance. As required by section 13.3 of NI 31-103, KYC information must be sufficient to enable a registrant to determine whether a proposed purchase or sale of a security for a customer is suitable for the customer. Mr. McDonald is responsible for monitoring and assessing Waverley's Representatives' compliance with KYC and suitability obligations of the firm and its Representatives.

[158] Registrants are required to apply KYC and suitability standards in carrying out their functions and they must have the proficiency to discharge the application of these standards (*Michalik* at para 23).

[159] One counterbalance to the conflicts of interest inherent in Waverley's business activities is an independent, robust and highly proficient KYC process.

[160] Waverley's initial KYC processes were not adequate. For example, Waverley's original KYC form was not clear that a client's asset calculation must be net of liabilities. This is a significant oversight of one of the most fundamental aspects of investor eligibility. Yet, this oversight was not detected by Mr. McDonald but rather by CRR Staff during its Compliance Review when a number of other significant deficiencies were also identified. The Panel, however, accepts that Waverley's KYC process has been updated and improved as a result of CRR Staff's prompting.

[161] While the Panel recognizes that Mr. McDonald has taken steps to correct the deficiencies related to Waverley's KYC process, we emphasize that Waverley's business practices continue to present risks to customers that require Mr. McDonald to respond proficiently to those specific risks.

[162] For example, Mr. McDonald testified that his focus as CCO is in-house compliance and that the Representatives are responsible for customer contact. Given this exclusive assignment of responsibility to the Representatives and given the inherent conflicts that exist, some follow-up with customers on at least a spot-check basis is warranted to assess the effectiveness of the KYC and suitability processes.

B. Conclusion

[163] The alignment of Waverley's Representatives' interests with the interests of Sponsoring Issuers creates pervasive conflicts of interest and supervisory and control challenges that necessitate the engagement of an experienced and skilled CCO.

[164] Proficiency is a principles-based standard necessarily custom-designed for the specific environment and risks of a particular registrant's business. Such proficiency is only partially gained through the successful completion of mandated exams. Indeed, Mr. McDonald testified that he views the specified course requirements relating to the exempt market as insufficient and that registrants are required to rely heavily on the gradual accumulation of experience gained through "on the job learning." During the Hearing and Review, Mr. McDonald said, "So you go through the proficiency requirements and you know really very little about running an exempt market dealer, their regulations, [S]taff's expectations. So it's really on the job learning."

[165] Mr. McDonald lacks the requisite practical, relevant CCO experience to augment his academic credentials and financial industry work experience. Prior to Waverley's registration, Mr. McDonald had been registered as a Representative for only three months, did not have previous compliance responsibilities, had no experience implementing policies and procedures based upon NI 31-103 and had not worked in an environment where he learned these skills.

[166] The evidence presented at the hearing before us strongly supports the view that Mr. McDonald does not possess sufficient proficiency to fulfill this challenging role for Waverley.

VI. REGISTRATION IS OTHERWISE OBJECTIONABLE

[167] Staff submits that Waverley's continued registration is otherwise objectionable.

[168] In light of our conclusions set out above, it is unnecessary for us to consider whether Waverley's registration is otherwise objectionable and we decline to do so.

VII. CONCLUSION

[169] For the reasons set out above, we find it proper to impose upon the registrations of Waverley and Mr. McDonald the terms and conditions set forth in Part VIII of this decision.

VIII. TERMS AND CONDITIONS

[170] The Panel has decided not to prohibit outright Waverley's business practice of sourcing Representatives from Sponsoring Issuers, as requested by Staff. Instead, we are imposing terms and conditions that address the contraventions of Ontario securities law and other material deficiencies we have found in Waverley's activities. These terms and conditions are designed to give Waverley and Mr. McDonald a further opportunity to demonstrate that they can conduct their activities in a manner that will, as a foremost goal, protect investors from the effects of the conflicts of interest pervading this business as well as from Waverley's inadequate systems of control and supervision. These terms and conditions directly address these deficiencies by means of improved disclosure to Waverley's customers and the Commission, more robust supervisory controls and procedures relating to Waverley's oversight of its Representatives' interactions with customers and a prohibition on certain roles that Representatives can perform for their Sponsoring Issuers and their affiliates.

[171] The Panel is also concerned that the way in which Waverley operates may encourage issuers to avoid registration as captive dealers with the possible attendant consequence of an insufficient window into the full scope of relationships between a Sponsoring Issuer and the principals associated with a Sponsoring Issuer on the one hand and a Representative on the other. Such a window is provided by the process of registering captive dealers. We have crafted terms and conditions designed to mitigate this potential gap in the effective identification and management of conflicts of interest while preserving the opportunity to realize the potential efficiencies arising from the reliance on a shared, registered and compliant dealer.

[172] These requirements do not apply directly to Sponsoring Issuers, as they are not parties to this proceeding, but rather apply to Waverley and set out the conditions under which Waverley can provide capital-raising services to these issuers. We note that shielding investors from the conflicts existing in Waverley's activities is of paramount importance and that Waverley itself can only be suitable for registration if investor protection is achieved in practice.

[173] We address particular deficiencies in Waverley's business practices regarding disclosure and record keeping, including due diligence, review of marketing

materials, documentation of referral arrangements and payments to referral agents.

[174] We also impose a term and condition on Mr. McDonald designed to increase his proficiency in handling conflicts of interest arising from Waverley's business activities.

[175] We hereby order that the following terms and conditions be imposed upon the registration of Waverley:

A. Waverley shall amend its agreements with each issuer whose securities are offered or sold by Waverley within sixty (60) days of the date of this Decision to require that the issuer:

i. submit to Waverley all materials, and any amendments to such materials, in any form or media (including, but not limited to, the issuer's or its affiliate's website), to be used in the offer, sale or marketing of its securities (including, but not limited to, training materials and scripts for use by Waverley's Representatives) for Waverley's approval in advance of its first use (or any continued use of pre-existing materials after the date of this Decision);

ii. agree to make such modifications as Waverley may require under subparagraph A(i) as a condition of Waverley's acceptance or continuation of its mandate in connection with the offering of such securities;

iii. provide to Waverley, if the issuer sponsors any Representative, the same information that it would be required to provide CRR Staff in an application for registration as a captive dealer, and on a continuing basis if the issuer were registered as a captive dealer with the Commission concerning the background of the issuer's executive officers and shareholders, or persons occupying similar positions or having a similar control relationship, however arising;

iv. shall not, along with any of its affiliates, directly or indirectly compensate Waverley's Representatives for any registrable activities in respect of securities offered through Waverley, and the issuer or its affiliate may only compensate an employee who is also a Waverley Representative for bona fide non-registrable activities for the issuer or affiliate;

v. provide to Waverley, if the issuer sponsors any Representative, immediate written notice of any facts or circumstances that could give rise to termination for cause by the issuer or Waverley of any of Waverley's Representatives employed by the issuer or any of its affiliates; and

vi. provide to Waverley, if the issuer sponsors any Representative, upon demand such materials and information that a captive dealer would be required to provide to the Commission;

B. Waverley shall immediately cease to provide dealer services to any issuer that does not comply with paragraph A;

C. Waverley shall maintain a file of all materials submitted to it under subparagraph A(i) as part of its books and records;

D. The marketing materials submitted to Waverley under subparagraph A(i) shall be signed by Waverley's UDP and CCO as evidence of their review and approval;

E. Upon request from the Commission, Waverley shall require from an issuer the delivery to it of any materials under subparagraph A(vi) and deliver forthwith such materials to the Commission upon receipt;

F. Waverley shall ensure the implementation of a reconciliation system, or other reliable process or processes, that provides reasonable assurance that no payments attributable to any offer, sale or marketing of a security of an issuer are made to any finder or referral agent unless and until arrangements between Waverley and such finders or referral agents are reflected in a binding written agreement and such arrangements are disclosed to each customer to the extent required by law;

G. As soon as reasonably practicable, Waverley shall prepare a clear and complete revised conflict of interest statement that includes a description of how a Representative's relationships with an issuer or its affiliates may affect the services and range of investment products the Representative offers to customers, which statement shall be prepared for all Representatives who have any direct or indirect economic, family or other material relationship with any issuer or its affiliate in a form satisfactory to CRR Staff (it being acknowledged that the information used in preparing such a statement is within Waverley's control and the accuracy and completeness of such statements is solely Waverley's responsibility), and Waverley shall deliver such approved statement to each customer of Waverley whose account is handled by any such Representative as required by Ontario securities law;

H. Within thirty (30) days of the date of this Decision, all communications by Representatives with customers, potential customers, finders and referral agents, other than in-person meetings, shall be conducted on e-mail servers, telephonic and other electronic communications systems operated by Waverley and capable of being recorded, monitored and stored by Waverley, and shall be subject to review by Waverley to address the risks arising from the conflicts of interest existing in Waverley's business activities as described in this Decision, and this procedure shall be authorized in a binding agreement entered into by Waverley with each of its Representatives to the extent required by law;

I. Waverley shall not permit any of its Representatives to perform executive responsibilities for any issuer or its affiliate, including, but not limited to, the roles of Chief Executive Officer, Chief Financial Officer, Chief Administrative Officer, General Partner, Managing Partner, Corporate Secretary, Chief Legal Officer or any similar role, regardless of title, involving the performance of comparable executive functions;

J. Waverley's written compliance procedures shall incorporate these terms and conditions; and

K. Waverley shall not submit any new applications for Representatives, and the processing of any applications for Representatives that are pending shall be held in abeyance until all of the foregoing terms and conditions have been implemented.

[176] We hereby order that the following terms and conditions be imposed upon the registration of Mr. McDonald:

A. As soon as practicable in the reasonable view of the Director, but no later than twelve (12) months after the date of this Decision, Mr. McDonald shall successfully complete a course, as approved by the Director, for senior executives in the securities industry that provides an in-depth understanding concerning best practices to identify, appropriately respond to and adequately disclose conflicts of interest.

Dated at Toronto this 1st day of March, 2017.

"D. Grant Vingoe"

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D. Grant Vingoe

"Monica Kowal"

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Monica Kowal

"William J. Furlong"

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William J. Furlong